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# Credit Transactions -- Knowledge and Priority Under Uniform Commercial Code Sections 9-301(1)(a) and 9-312(5)

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directly, and the compulsory amendment altering liquidation preferences—which have been held invalid in prior New Jersey cases<sup>25</sup>—will be re-examined under the broad interpretation of reserved powers in *Brundage*.<sup>26</sup>

Although the court leaves many questions unanswered in *Brundage*, its overall significance in the development of corporate law is threefold: (1) it represents an increasing awareness by the courts that the needs of the modern corporate require both legislative flexibility in enabling corporations to adjust to changing economic conditions and the compromising of minority interests in favor of a more democratic process within the corporation; (2) it possibly represents a shift in the means employed to protect the minority interests—from the random application of such nebulous concepts as “vested rights” and from the harsh requirement of unanimity, to the direct imposition of equitable limitations on majority shareholder action; and (3) it should provide the impetus for the remaining states which hold to a more restricted view of the reserved powers to reconsider their position in light of modern corporate needs.

NEILL G. MCBRYDE

### Credit Transactions—Knowledge and Priority Under Uniform Commercial Code Sections 9-301(1)(a) and 9-312(5)

In *Bloom v. Hilty*<sup>1</sup> the plaintiff sold and delivered to Charles Hilty a quantity of gas drilling pipe. At the time of the sale it was orally agreed that title to the pipe would remain in the plaintiff until the full purchase price was paid. Subsequently Hilty executed a chattel mortgage to the defendant covering the pipe sold to Hilty by the plaintiff. At the time the mortgage was executed the defendant knew of the plaintiff's claim of an interest in the pipe. The defendant duly perfected his security interest by filing a financing statement. The plaintiff did not perfect his interest.

In holding that the defendant's interest was entitled to priority

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<sup>25</sup> See H. BALLENTINE and G. STERLING, CALIFORNIA CORPORATIONS LAWS 9 (1938); Gibson, *How Fixed Are Class Shareholder's Rights*, 23 LAW & CONTEMP. PROB. 283, 294 (1958); Lattin, *A Primer on Fundamental Corporate Changes*, 1 W. RES. L. REV. 3, 26 (1949).

<sup>1</sup> 427 Pa. 463, 234 A.2d 860 (1967).

over that of the plaintiff, the Supreme Court of Pennsylvania applied Uniform Commercial Code sections 9-301(1)(a) and 9-312(5)(b). The former section provides that "an unperfected security interest is subordinate to the rights of persons entitled to priority under section 9-312." Under section 9-312(5)(b) where one of two conflicting interests is perfected,<sup>2</sup> the first to perfect is given priority. The court held that lack of knowledge of a prior unperfected security interest was not a requirement for priority under these sections.<sup>3</sup> Thus the defendant's knowledge of the prior interest at the time his interest attached was insignificant. The court reasoned that since neither section explicitly makes lack of knowledge a prerequisite for its operation, knowledge is irrelevant. Moreover, the comments to section 9-312(5) support the view that lack of knowledge is not required.<sup>4</sup>

The court's position is clearly correct. The argument that knowledge is a factor would not have been advanced were it not for pre-Code law. Prior to the Code's adoption most states made knowledge a factor in determining priorities with the usual result that a perfected junior interest was subordinated to an unperfected prior interest of which the holder of the junior interest had knowledge.<sup>5</sup> Except for the two sections under consideration (9-301(1)(a) and 9-312(5)) the Code has either expressly adopted or rejected this position in its priority sections.<sup>6</sup> Thus, it has been suggested that the

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<sup>2</sup> This section does not apply where both interests are perfected by filing. UNIFORM COMMERCIAL CODE § 9-312(5)(a) covers this situation.

<sup>3</sup> *Accord, In Re Gunderson*, 4 UCC REPORTING SERV. 358 (S.D. Ill. 1967); 1 P. COOGAN, G. HOGAN, & D. VAGTS, SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE 177 n.23 (1967); 2 G. GILMORE, SECURITY INTEREST IN PERSONAL PROPERTY § 34.2, at 902 (1965) [hereinafter cited as GILMORE]; Felsenfeld, *Knowledge as a Factor in Determining Priorities under The Uniform Commercial Code*, 42 N.Y.U.L. REV. 246, 247 (1967) [hereinafter cited as Felsenfeld]; Smith, *Article Nine: Secured Transactions-Perfection and Priorities, The Uniform Commercial Code in North Carolina: A Symposium*, 44 N.C.L. REV. 753, 793 n.179 (1966).

<sup>4</sup> UNIFORM COMMERCIAL CODE § 9-312(5), comment 4, examples (1) ("it makes no difference whether or not A knew of B's interest when he made his advance"), (2) ("it makes no difference whether or not he knows of the other interest at the time he perfects his own"), (3) ("A has priority whether or not he knows of B's interest when he files"), (4) ("it makes no difference whether or not A knows of B's intervening advance when he makes his second advance").

<sup>5</sup> 1 GILMORE § 21.2, at 584; Felsenfeld, *supra* note 3, at 249.

<sup>6</sup> The pre-Code position is adopted by UNIFORM COMMERCIAL CODE § 9-301(1)(b); 9-301(1)(c); 9-301(1)(d); 9-307(2); 9-308. It is rejected by UNIFORM COMMERCIAL CODE §§ 9-307(1); 9-308; 9-312(2); 9-312(3).

requirement of lack of knowledge may have been inadvertently omitted from these two sections and that it should be supplied by analogy.<sup>7</sup> However plausible this argument may seem, there is little question that the lack of knowledge requirement was deliberately omitted. By the explicit use of knowledge in the other sections of the Code the drafters indicated their awareness of its significance.<sup>8</sup> Other evidence of this intent is found in the manner in which the pre-Code position was changed. Prior to 1956, Code section 9-301(1)(b) provided that a subsequent party with knowledge would not take priority.<sup>9</sup> This section was replaced in the present Code by the two sections under consideration, neither of which require lack of knowledge. In light of these events knowledge should not be implied by analogy to the other Code sections.<sup>10</sup>

It has been suggested that the good faith requirement of section 1-203 may supply the knowledge factor.<sup>11</sup> This court rejected that contention. It correctly concluded "that some leading on or other basis for estoppel would seem necessary to deprive one of priority given him by statute."<sup>12</sup> The obvious meaning of section 9-312(5) is that good faith in the lack of knowledge sense is not to be a limitation. Once it is concluded that knowledge was deliberately omitted as a factor under this section it naturally follows that a secured party can act in good faith even though he has knowledge of the prior unperfected security interest.

The *Hilty* decision is also illustrative of the difficulties encoun-

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<sup>7</sup> 2 GILMORE § 34.2, at 901.

<sup>8</sup> Felsenfeld at 249.

<sup>9</sup> 2 GILMORE § 34.2, at 898.

<sup>10</sup> It seems that the Code is in accord with prior North Carolina law. Before the Code's adoption the first security interest to be registered prevailed, *Commercial Inv. Trust v. Albemarle Motor Co.*, 193 N.C. 663, 177 S.E. 874 (1927). Furthermore, notice or actual knowledge on the part of the prior interest on the part of lien creditors or purchasers for value [Included in this classification is the chattel mortgagee, *Odom v. Clark*, 146 N.C. 544, 60 S.E. 513 (1908)], would not take the place of actual registration. *Bank v. Cox*, 171 N.C. 76, 87 S.E. 967 (1916); *Piano Co. v. Spruill & Bro.*, 150 N.C. 168, 63 S.E. 723 (1909).

<sup>11</sup> Coogan, *Article 9 of the Uniform Commercial Code: Priorities Among Secured Creditors and the "Floating Lien,"* 72 HARV. L. REV. 838, 858 n.80 (1959). For a general discussion of good faith see Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); Comment, *Good Faith Under the Uniform Commercial Code*, 23 U. PITT. L. REV. 754 (1962).

<sup>12</sup> 427 Pa. 463, 464, 234 A.2d 860, 864 (1967). This same result was suggested in 1 P. COOGAN, G. HOGAN, AND D. VAGTS, *SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE* 177 n.26 (1967).

tered in applying the Code. The court without mentioning the point assumed that the plaintiff's oral reservation of title created an enforceable security interest.<sup>13</sup> It seems that Code section 2-401(1) was the basis for this assumption. This section provides that "any retention or reservation by the seller of title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest."<sup>14</sup> Under section 2-401(2) the seller, to reserve title once the debtor has lawfully obtained possession of the property, must enter an explicit agreement with the debtor. To create a security interest under the Sales Article the provisions of the Secured Transactions Article must be fully met.<sup>15</sup> Section 9-203 (1)(b) provides that once the debtor has possession of the goods a security interest is not enforceable against either the debtor or third persons unless "the debtor has signed a security agreement which contains a description of the collateral . . ."<sup>16</sup> Since the only agreement in *Hilty* was oral, the plaintiff's security interest was unenforceable.<sup>17</sup> Thus the court needlessly dealt with the problem of priority under sections 9-301(1)(a) and 9-312(5) as they are applicable only where conflicting security interests in the same collateral exist.

One of the primary purposes of the Code is "to make uniform the [commercial] law among the various jurisdictions."<sup>18</sup> This end can be attained only if the decisions of one jurisdiction are fol-

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<sup>13</sup> In the course of its opinion the court often referred to a lease-purchase agreement made between the plaintiff and *Hilty*. As this agreement was executed subsequent to the execution and perfection of the defendant's security interest it should have no effect on the priorities between the conflicting interests.

<sup>14</sup> The vendor's interest would be a purchase money security interest. *Evan's Prod. Co. v. Jorgensen*, — Ore. —, 421 P.2d 978 (1966); UNIFORM COMMERCIAL CODE § 9-107. It should be noted that the rights, obligations and remedies of a party under the Secured Transactions Article are not affected by the location of title. UNIFORM COMMERCIAL CODE § 9-202.

<sup>15</sup> UNIFORM COMMERCIAL CODE § 9-102(1)(a). This section provides that The Secured Transactions Article applies to all transactions which are intended to create a security interest. "Security interest" is defined by Code section 1-201(37). The definition specifically includes those interests which arise under section 2-401.

<sup>16</sup> An exception to this rule exists where the security interest arises solely under the Sales Article. If in such a case the debtor is neither in, nor lawfully obtains, possession of the goods no written agreement is necessary. UNIFORM COMMERCIAL CODE § 9-113(a).

<sup>17</sup> *Evan's Prod. Co. v. Jorgensen*, — Ore. —, 421 P.2d 978 (1966); *Grantham v. Paul*, 203 Pa. Super. 158, 199 A.2d 519 (1964).

<sup>18</sup> UNIFORM COMMERCIAL CODE § 1-102(2)(c).

lowed by other jurisdictions. This case is illustrative of one of the main obstacles to the achievement of that purpose. The court's reasoning was faulty. Furthermore, it is unreasonable to assume that other courts will perpetuate a mistake for the sake of conformity. As a result, the uniformity of the Code will be further disrupted unless the Supreme Court of Pennsylvania refuses to recognize this decision, insofar as it relates to the creation of a security interest, as precedent.

JOHN M. MASSEY

### Damages—Rightful Recovery for Wrongful Death— The Income Tax Factor

Most problems involving the income tax concern a resolution of whether or not the tax is applicable. There *is*, however, a problem that arises because the tax is unquestionably *not* applicable. Under the Internal Revenue Code, damage awards for personal injury and wrongful death are tax exempt.<sup>1</sup> The recipient of such an award is allowed to exclude it from his gross income for income tax purposes. Because of this, the court in *Brooks v. United States*<sup>2</sup> held that the amount of damages to be given to the widow and children of a South Carolina decedent, whose wrongful death was caused by an agent of the federal government, should be computed so as to give recognition to this tax saving. This was done by using a net earnings instead of a gross earnings figure as the measure of future earnings lost as a result of decedent's death. This position taken by the court is in the minority in the United States.<sup>3</sup>

The question of whether to take cognizance of the tax-exempt status of the award when computing damages is an important one." "The increase in the amount of damage verdicts . . . and the high level of income taxes makes the question immediate."<sup>4</sup> It seems

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<sup>1</sup> The Internal Revenue Code expressly exempts from gross income "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness." INT. REV. CODE OF 1954, § 104(a)(2). Wrongful death damages are also non-taxable. Rev. Rul. 54-19, 1954-1 CUM. BULL. 179. See also N.C. GEN. STAT. § 105-141(b)(5) (iv) (Supp. 1967).

<sup>2</sup> 273 F. Supp. 619 (D.S.C. 1967).

<sup>3</sup> See Annot., 63 A.L.R.2d 1393, 1395-96 (1959).

<sup>4</sup> Note, *Income Taxation and Damages for Personal Injuries*, 50 KY. L.J. 601, 601 (1962).